DIRECTIONS FOR A NATIONAL
AGRICULTURAL DEVELOPMENT STRATEGY
FOR CANADA

Farm Finance

A Saskatchewan Position Paper
Prepared for the First Ministers' Conference
on the Economy

November 28-29, 1985

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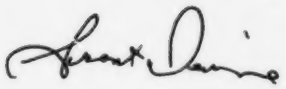
PREFACE

Today, Canadian agriculture is facing an economic environment which is fundamentally different than was the case in the past. The changes which have occurred call into question old approaches to national agricultural policy and point to the necessity for review and modification to meet today's needs.

This paper is one of four prepared as background to discussions on agriculture at the **First Ministers' Conference** in November 1985. The papers incorporate the views of many agricultural organizations presented as **briefs to the Government of Saskatchewan** and many of the issues raised at the **Saskatchewan Agriculture Conference** of October, 1985. They address the urgent requirement for a **national disaster program** and the need to review and modify policies, programs and regulations which affect **farm finance, trade and new technology and resource development.** These documents have been prepared to encourage public and farmer participation in discussions on the future of agriculture in Canada.

The Government of Saskatchewan is dedicated to the furtherance of agricultural prosperity. It is hoped that the ideas in these papers will contribute to a federal-provincial agreement on the need and the process to establish a new **National Agricultural Policy for Canada.**



Grant Devine
Premier of Saskatchewan

Regina, Saskatchewan
November, 1985

TABLE OF CONTENTS

	Page No.
Preface	(i)
INTRODUCTION	1
CURRENT SITUATION	1
Farm Failures	
Land Values	
REASONS FOR THE CURRENT SITUATION	4
Monetary and Fiscal Economic Climate	
Land Values	
Cost-Price Squeeze	
Capital Requirements of Agriculture	
The Farm Finance Infrastructure	
PRIORITIES FOR REVIEW IN FARM FINANCE	13
The Monetary Climate	
The Fiscal Climate	
Interest Rate Stability	
Revenue Generating Pricing Options	
Intergenerational Transfer of Farms	
Current Farm Debt Situation	
Improved Farm Management and Financial Planning	
CONCLUSIONS	18
RECOMMENDATIONS FOR ACTION	19

FARM FINANCE

INTRODUCTION

The farm financial crisis in Canada today is serious and threatens the very viability of this major Canadian industry. Low commodity prices, high interest rates, and declining land values have combined to place many farmers in a financial situation where high debt obligations cannot be met by current depressed cash flows. The inability to meet obligations, a major problem by itself, also threatens the livelihood of businesses dependent on a profitable farm sector. In order to deal with agriculture finance within a National Agricultural Policy, this paper will provide a review of the current farm financial crisis, provide reasons for its occurence, and outline priorities for review in a national farm finance policy.

CURRENT SITUATION

A major study of the financial structure of Canadian farmers was conducted by the Farm Credit Corporation (FCC) in 1984 in collaboration with Statistics Canada, Agriculture Canada and the Canadian Federation of Agriculture. The FCC survey concluded that as many as 17 percent of all Canadian farmers were under severe financial stress. Seven percent of farms in 1984 were in moderate financial difficulty; 76 percent were considered more stable primarily because they had the minimum equity needed for a reasonable chance of survival. The study also reported that as many as 1,700 farmers may be headed for immediate financial collapse.

The survey reported that average farm investment at the beginning of 1984 was $508,469, a 2 percent increase over 1981. Average farm debt was estimated at $90,618, which is a 16 percent increase over the same three year period. This implies a decline in the equity position of the average Canadian farmer from 85 to 82 percent. A review of the equity position by province reveals that Alberta suffered the most severe decline in equity, going from 90 percent in 1981 to 84 percent in 1984. Although the decline in the average Canadian equity position is real, the equity level relative to other sectors in the economy is impressive. The FCC and others suggest that a relatively high equity position may be necessary in agriculture because the low and unpredictable cash flow from farm operations limits a farmer's ability to carry high debt loads.

Canadian Farmers by Equity Group

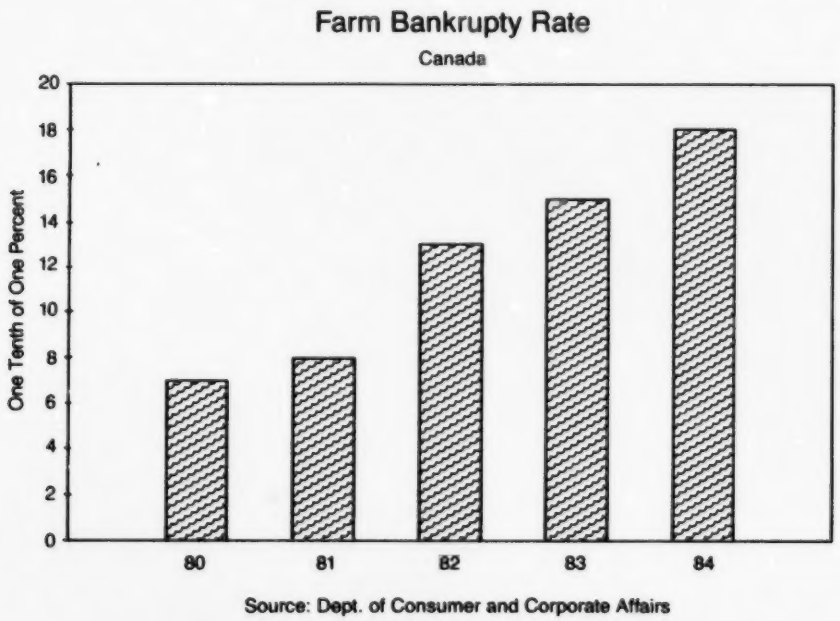
Equity Group (Percent)	Average Number of Years Farming	% of Total Farmers
0 - 20	10	2.5
21 - 40	8	4.2
41 - 60	12	9.5
61 - 80	15	18.4
81 - 100	25	65.4
		100.0

Source: Farm Credit Corporation

> "The most recent entrants to the industry, young farmers, who are often highly productive, carry the most burdensome of debt loads." (Western Canadian Wheat Growers Association brief)

The financial difficulties experienced by Canadian farmers varies significantly depending on the financial structure of the individual farm. The farmers most vulnerable are those with low equity. As of January 1984, the FCC reported that 16 percent of Canadian farmers had equity of 60 percent or less. These farmers are significantly more vulnerable to natural disasters and short term fluctuations in farm income, and interest rates.

Farm Failures

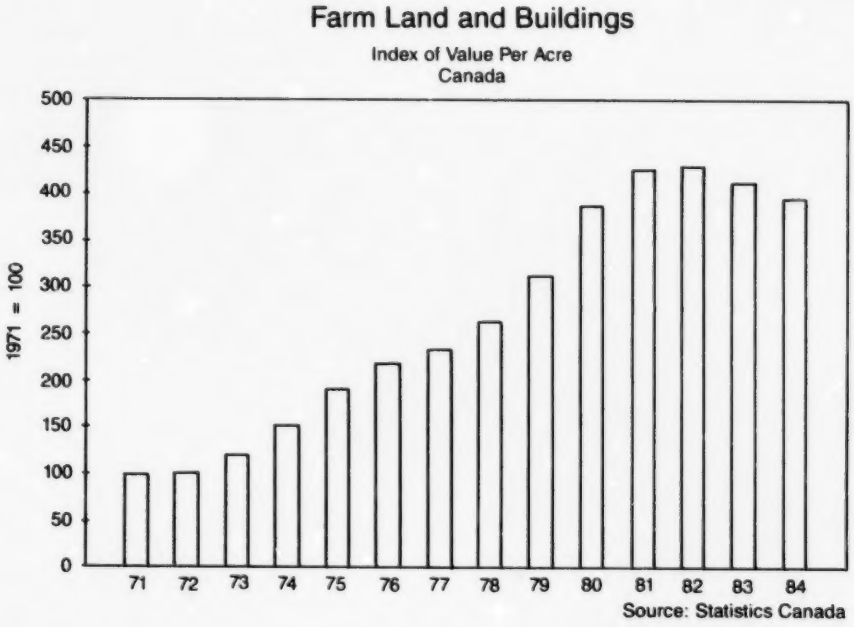


Source: Dept. of Consumer and Corporate Affairs

The rate of farm bankruptcies in agriculture has increased every year for the past five years. Farm bankruptcies reported in 1979 totalled 124 and increased to 551 in 1984. Since only incorporated farms can be petitioned into bankruptcy, these statistics do not fully portray the seriousness of the current financial situation. When combined with information on farm foreclosures, the magnitude of the farm financial problems is more readily apparent. For example, the number of notices to foreclose in Saskatchewan alone were 196 in 1981-82 and rose dramatically to 380 in 1983-84. The statistics on farm bankruptcies and foreclosures may still underestimate the severity of the situation because they do not capture those farmers who decide to sell part or all of their assets rather than be forced into insolvency.

Land Values

One of the consequences of the current economic downturn in agricultural markets, concurrent with substantially higher real rates of interest, is that the relative attractiveness of agriculture as an investment has declined. Statistics Canada reports that the value of farm land and buildings per acre began to decline in 1983. By 1984, land values per acre were 8.3 percent below the peak recorded in 1982.



This is a startling contrast to the seventies when the attractiveness of agriculture was enhanced by the combination of low real interest rates, booming commodity prices, and accelerating inflation. Farm incomes increased significantly and farm land values boomed. The value of farm land including buildings on a per acre basis increased more than fourfold during the 1971 to 1982 period.

REASONS FOR THE CURRENT SITUATION

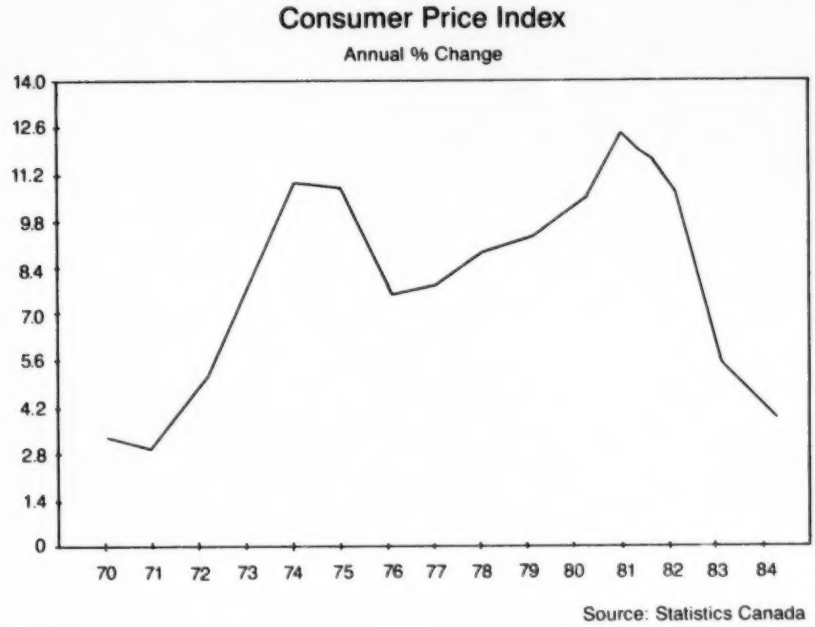
Agriculture, by its nature, is an industry subject to substantial cyclical variations in output and income. Many of the problems faced by Canadian farmers, today and in the past, have been the product of events outside their sphere of influence. Prices for most of Canada's agricultural products are determined on world markets by a complex interaction of climatic, political and economic influences. Consequently, price movements have been and continue to be volatile and difficult to forecast. Nevertheless, the cost of farm inputs, such as fertilizers and chemicals, continue to increase at a fairly steady rate. The combination of a volatile revenue stream and steadily rising costs of production results in the Canadian farmer facing a highly variable income.

In the eighties, however, the traditional problems of agriculture have been compounded by changes in the monetary and fiscal climate, protectionist agricultural policies, and depressed world commodity markets. Indeed, the presence of this new economic situation has had important and detrimental consequences for the capital intensive agriculture and resource sectors. The high capital to labour requirement of modern agriculture implies that farmers experience a high degree of exposure to fluctuations in credit markets.

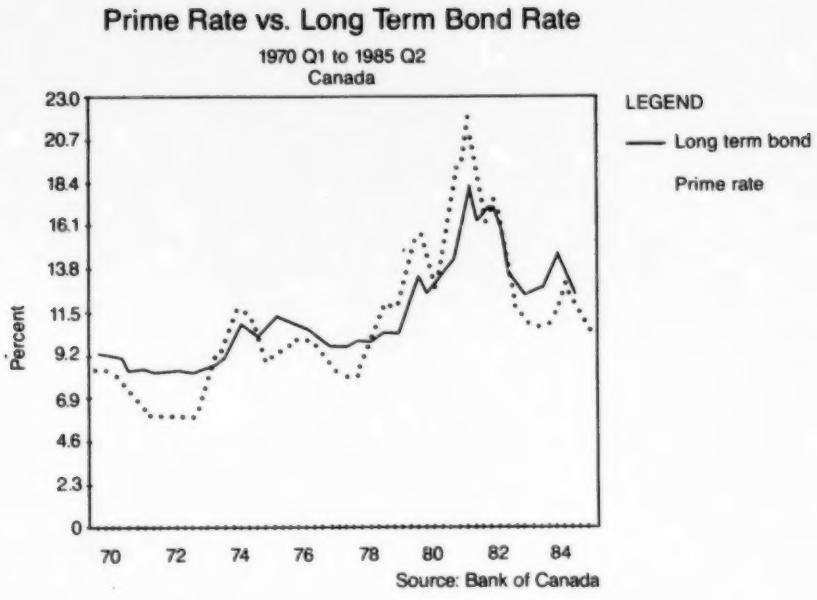
Monetary and Fiscal Economic Climate

The expansionary monetary and fiscal policy regimes of North American governments during the late sixties and early seventies resulted in a relatively rapid acceleration in the rate of inflation. In Canada, inflation, as measured by the consumer price index, rose from 2.9 percent in 1971 to over 10 percent by mid-decade. The level of inflation in the seventies was boosted by two oil price shocks, the first during 1973-74 and the second during 1979-80.

In the 1970s climate of high and persistent inflation and low real rates of interest, inflationary expectations became entrenched in the business and personal sectors of the economy. Inflation influenced the distribution of wealth and income and distorted production and inventory decisions. Firms could obtain price increases unrelated to costs of production, competitive position, or other considerations ordinarily important to a firm's pricing policy. Inflation indexed wages hampered government efforts to manage inflation.

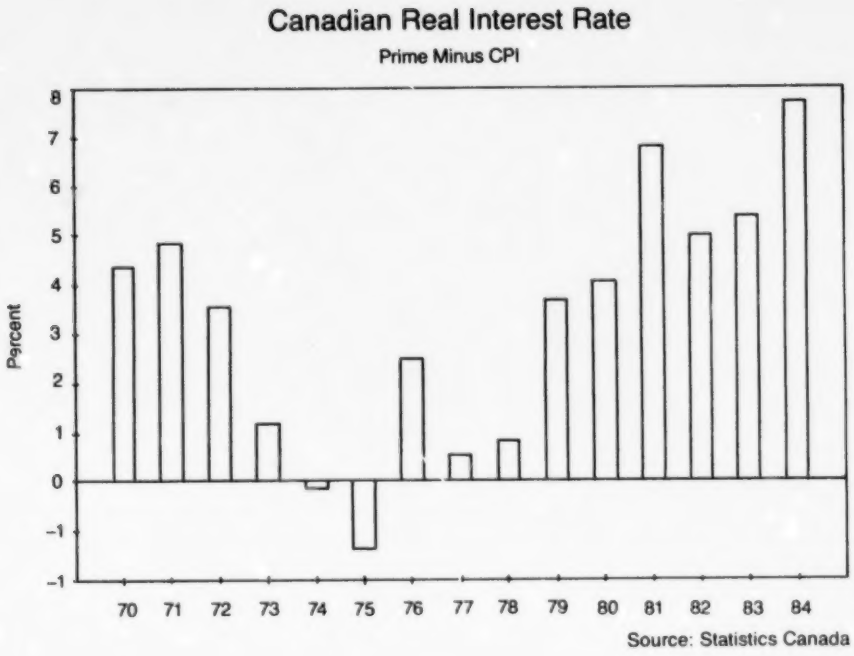


The second oil price shock in 1979-80 led many central banks and governments in the industrialized world to target inflation as a major policy thrust. The combination of an extremely restrictive monetary stance by the U.S. Federal Reserve Board and the expansionary fiscal policies of the U.S. administration resulted in unprecedented increases in short and long term interest rates. In Canada, the Bank of Canada followed the lead of the U.S. and short term interest rates, such as the Canadian prime lending rate, rose from 12.0 percent in the first quarter of 1979 to over 21 percent by the third quarter of 1982. Long-term bond rates rose from 10.5 percent to 16.0 percent over the corresponding period. Britain and other industrialized nations adopted similiar restrictive monetary policies.



These anti-inflationary policies were effective in reducing inflation but at a considerable cost to other aspects of the economy. Reduced international and domestic price pressures led to a drop in the rate of inflation in Canada from the 1981 high of 12.5 percent to the modest 4.4 percent recorded in 1984. The continuance of high nominal rates of interest, combined with the lower inflation profile, implied that real interest rates (nominal rates discounted for inflation) reached unprecedented levels. Real interest rates in Canada rose from 3.7 percent in 1979 to 7.7 percent in 1984. Although they have moderated over recent months, real interest rates continue at levels significantly higher than the seventies.

Real interest rates in the 1970-79 period averaged 1.6 percent compared to 6.2 percent for the 1980-84 period. The shift in monetary and fiscal policy, the Third World debt crisis, and deregulation of U.S. financial markets have introduced a significant degree of volatility in the credit markets of the 1980s.



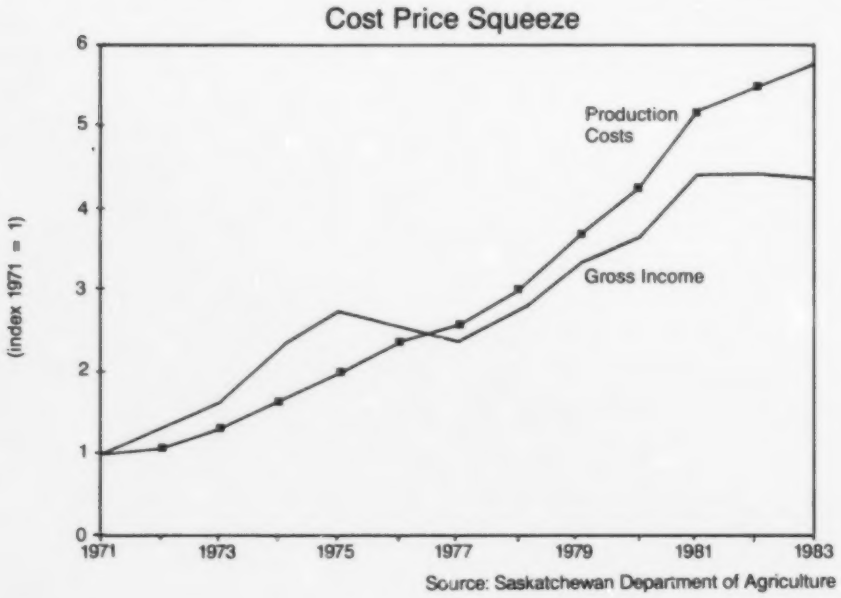
Land Values

The changed economic climate has caused land prices in agriculture to decline, eroding the equity base of Canadian farmers. This is a distinct contrast to the events of the seventies when the general inflationary climate and booming agricultural commodity prices boosted land values.

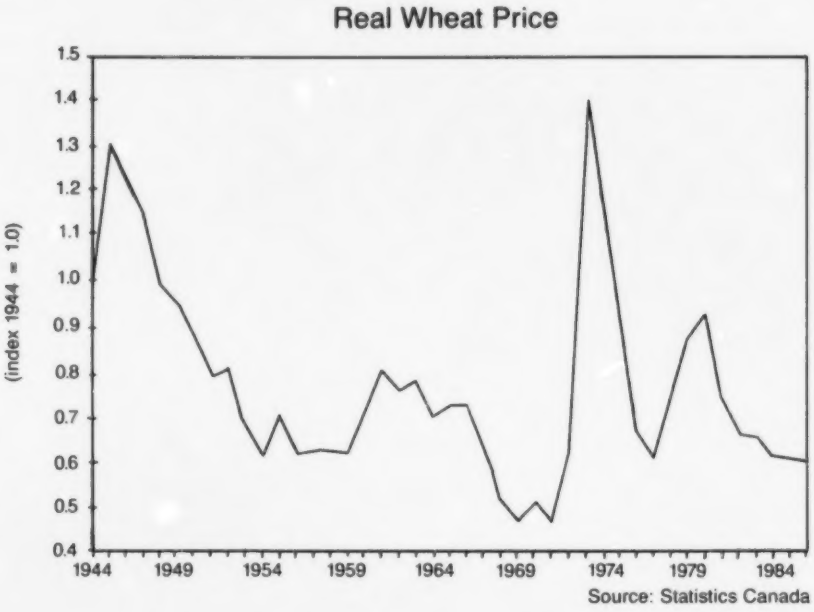
With inflation and the expectation that commodity prices would, over the long run, follow this general inflationary trend, it was anticipated that farmers borrowing money would see the real value of their debt load decline over time. Lenders were comfortable while land prices were rising and borrowers took comfort in the knowledge that if debt servicing did become a problem it was always possible to dispose of a portion of their land holdings, realize a substantial capital gain, and thereby reduce their debt load. This environment was conducive to a substantially increased debt load for many farmers just entering the industry or expanding their operations. With negative or low real interest rates many farmers were eager to debt finance. The financial position of farmers who borrowed heavily during this period was considered sound as long as real interest rates remained low, commodity prices remained favourable, and land prices continued to rise. This situation did not persist.

Cost-Price Squeeze

The new monetary climate of the eighties has reduced economic growth and precipitated a reduction in the effective demand for agricultural products and other commodities. Importing nations, strapped with high debt loads and high interest rates, find it particularily troublesome to secure financing for imports. The world agriculture situation has recently deteriorated due to record grain harvests, subsidies and surpluses. The consequence has been a significant decline in agricultural prices.



Real wheat prices, despite temporary upswings in 1973-74 and 1978-80, have steadily declined since the 1940s. The cost of farm inputs since the early seventies, however, have continued to increase at a fairly steady rate. As a consequence, farmers in Canada have been caught in a squeeze between declining prices for their output and increasing costs of production. Net farm incomes have suffered.

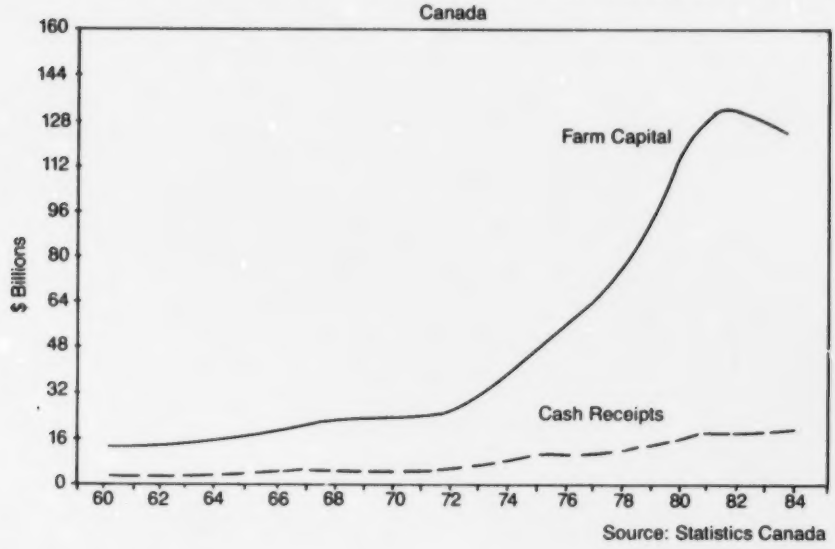


Capital Requirements of Agriculture

The changed economic and financial climate has important implications for agriculture because of its extremely capital intensive structure. In 1984, the total value of all farm capital in Canada was $123 billion, including land and buildings, implements and machinery, livestock, and poultry. This compares with $20.2 billion in annual farm cash receipts. For every dollar of annual farm cash receipts, there is $6 of capital on Canadian farms. Consequently, agriculture relies heavily upon capital financing.

The value of farm capital increased at a rapid rate over the past thirty years due to the substitution of modern equipment for labour and the rising value of farm land. Since 1982, however, the value of farm capital has declined, primarily due to a softening of farm land prices.

Value of Farm Capital vs. Cash Receipts



Agriculture has other characteristics which create special capital financing requirements and imply significant exposure to credit market fluctuations.

i) Agriculture consists predominately of individual owner-operated businesses. These businesses are relatively small scale and rely on debt financing. Businesses in other sectors often issue equity shares in the business when additional financing is required, thereby attracting capital and diversifying the risk of ownership. When a farmer requires financing, he generally approaches a bank, credit union or public lending agency for a loan. The farmer retains the risk of ownership. The farmer's desire to attract outside equity investment in his enterprise and his scope for doing so is more limited than in many sectors.

ii) The capital intensive nature of agriculture and the owner-operator nature of industry create special problems of transferring ownership from one generation to the next. This is in contrast to the modern corporation which transfers ownership by gradually transferring common shares between investors. Owner-operators in agriculture typically transfer the entire enterprise every generation. The process implies that procurement of the major long term capital required for ownership transfer is extremely difficult. The average new operator is immediately placed in an extremely highly leveraged and risky financial position. That risk has increased substantially in the past several years due to higher and more volatile real interest rates.

iii) "Operating capital has become as important as fixed asset capital for today's high input long term rotational farmer." (Saskatchewan Canola Growers Association)

Agriculture requiries a large annual injection of operating capital to purchase inputs like fertilizers, chemicals, fuel, seed and machinery repairs. This need for operating capital is partly explained by the inherent lag between cost outlays for these inputs and the receipt of revenue from the sale of agricultural output. Operating capital has increased steadily in recent decades with the advent of new technologies involving greater use of fertilizers, chemicals and fuels.

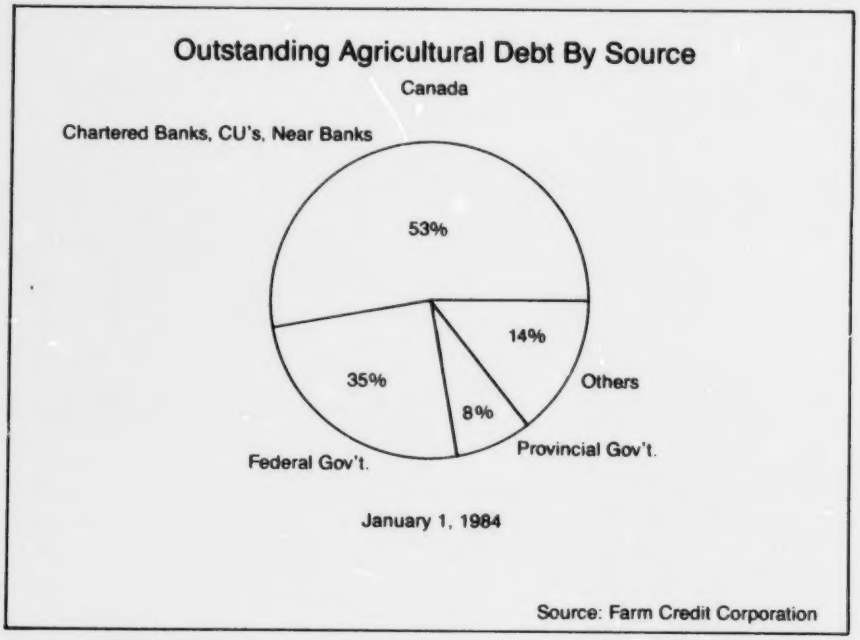
Many of the farm decisions made during the seventies were not blatantly incorrect decisions from a managerial point of view. These decisions, however, required steadily increasing land values, good commodity markets, and low real rates of interest in order to yield a profit. The economic and financial climate changed and many farmers are now in severe financial stress. Indeed, farmers have often been supported by explicit government interests to expand production. These interests, in turn, were supported by public and private financial institutions, who, by encouraging debt financing with surplus loanable funds and low interest rates, also contributed to the current financial circumstances. Consequently, some of the responsibility for resolving the current situation rests with financial institutions and governments.

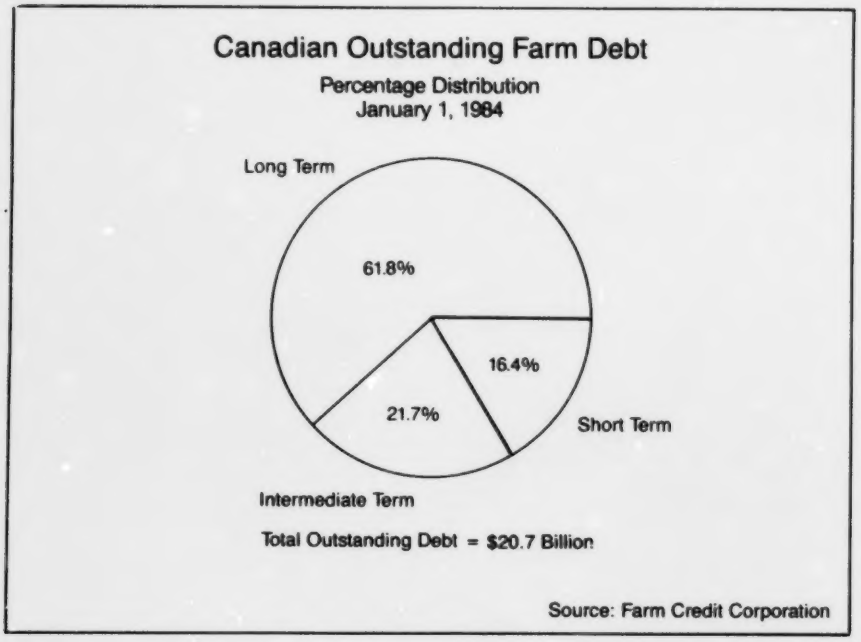
The Farm Finance Infrastructure

Past developments in farm finance have produced an extensive and complex financial infrastructure to serve Canadian agriculture. Provincial direct lending agencies were established as early as the second decade of this century. The federal government became involved in direct lending through the Soldier Settlement Board, later to be replaced by the Veterans Land Act of 1942, and through the Canadian Farm Loan Board of 1929, later replaced by the Farm Credit Corporation in 1959. Much of the direct government involvement was in response to the perception that farmers paid higher interest rates than other borrowers and they could not obtain the repayment terms necessary to finance a farm operation.

Direct lending in Canadian agriculture today consists of an extensive private and public farm credit system. The private side consists of chartered banks, credit unions, insurance, trust and loans companies, finance and supply companies, dealers, stores and individuals. The public side includes the Farm Credit Corporation, the Federal Farm Business Development Bank and numerous provincial lending agencies. Loans under the Veterans Land Act still account for a portion of outstanding loans but lending has been wound down. Chartered banks, credit unions, insurance, and trust and loan companies combined handle over one-half of all farm lending. The

federal government is responsible for 25 percent of outstanding debt, primarily in long term loan capital. Provincial lending agencies represent 8 percent of outstanding loans while supply dealers, individuals and stores account for the remaining 14 percent.





Governments have also become involved in the farm finance infrastructure through indirect and, in many cases, ad hoc means. These include, for example, the federal Farmer's Creditors Arrangement Act of 1934 which provided intermediate term farm loans to allow debt adjustment; the Farm Improvement Loans Act that guaranteed bank losses; the 1967 amendments to the Bank Act to allow chartered banks to engage in mortgage financing; numerous provincial loan guarantee programs; federal and provincial interest rate rebate programs; debt moratorium legislation; cash advances such as Prairie Grain Advance Payments and livestock cash advances by federal and provincial governments. In a broader context, governments have attempted to finance Canadian agriculture in response to production and market instability, through stabilization programs, federal-provincial crop insurance programs and disaster assistance grants.

PRIORITIES FOR REVIEW IN FARM FINANCE

Past public policies have changed the financial infrastructure to fulfill a number of criteria important to agriculture including production and market cyclicality, agricultural development, increasing capital intensiveness and single proprietorship. Past initiatives, however, were taken within a relatively stable and predictable monetary environment. Agriculture, like other industries, is faced with the prospect of adjusting to an uncertain monetary world of high and unpredictable real interest rates. A national farm finance policy must recognize the implications of this climate on the current financial infrastructure.

> "Effective programs must be developed to adequately meet short term crises within the context of longer term sound production, marketing and stability planning." (College of Agriculture, University of Saskatchewan brief)

The priorities for review in farm finance can be summarized as follows:

(i) the monetary climate;

(ii) the fiscal climate;

(iii) interest rate stability;

(iv) revenue generating pricing options;

(v) intergenerational transfer of farms;

(vi) the current farm debt situation; and

(vii) improved farm management and financial planning.

Principles

A national farm finance policy should be developed and guided by the following principles:

(i) programs should be actuarily sound policies which do not distort markets;

(ii) programs should allow farmers to make production and investment decisions based upon stable, predictable costs of financing;

(iii) governments must reduce financing barriers to entry in agriculture to facilitate intergenerational transfer of farm assets and increased opportunity for people to farm;

(iv) programs should provide uniformity and consistency of capital availability for agriculture across Canada in order to achieve production based upon comparative advantage.

The Monetary Climate

High and volatile credit costs and sluggish demand in many industrialized nations have heightened the level of uncertainty and risk associated with economic decisions. Indeed, the presence of this economic climate has had important and detrimental consequences for the capital intensive agriculture and resource sectors.

The objective of monetary policy in Canada continues to be the pursuit of a low or non-inflationary economy. In the 1984 Annual Report of the Bank of Canada Governor Gerald K. Bouey reaffirmed this objective by stating:

> "We are not going to realize the goal of sustained economic prosperity, a goal on which we surely all agree, without a relatively stable price level and confidence that such stability can be counted on in the future." (Bank of Canada, Report of the Governor, 1984, page 7)

The Canadian economic climate is improving. Output has continued to expand for the past 10 quarters and the economy in 1985 has demonstrated a renewed strength in many of the components crucial to a sustained and balanced economic recovery. Capital intensive sectors, particularly agriculture, have not, however, benefitted from the economic recovery. There is a need to refocus the economic objectives of monetary and fiscal policy.

1. The Bank of Canada should place **less emphasis** on the value of the exchange rate and worry more about the general economy. We need to **moderate** the frequent and large swings in the level of interest rates perceived as needed to

maintain an appropriate value of the Canadian dollar. This would provide a more stable financial climate and reduce the degree of uncertainty and risk involved in economic decisions faced by all sectors in the Canadian economy including agriculture.

2. Monetary authorities in the U.S. and Canada should reaffirm their long term commitment to reducing the level of interest rates and thus provide a financial climate conducive to structural adjustment and sustained economic expansion.

3. Governments must work to reduce agricultural programs which divorce producers from relevant market signals. Programs that distort production decisions and threaten the viability of naturally competitive producers, such as the export bonus program adopted by the U.S. and the massive price subsidies employed by the European Economic Community, only serve to increase the degree and magnitude of instability on world agriculture markets.

The Fiscal Climate

Canadian agriculture is currently in the throes of a major squeeze between declining real prices for output and rising costs of inputs. The cost-price squeeze has recently been compounded by successive drought on the southern Prairies and high and volatile real interest rates. The creation of a fiscal environment which facilitates productivity improvements and, thus, our ability to compete in world markets, is a major consideration of a national farm finance policy.

A reduction of federal and provincial taxes on farm inputs such as fuel, fertilizer, and chemicals would significantly reduce the severity of the cost-price squeeze and thus bolster net farm incomes. A policy of this type would benefit all farmers. Those farmers in financial distress will need targetted assistance.

Interest Rate Stability

Highly variable interest rates will not produce the capital investment in agriculture necessary to maximize growth and development. In the absence of a major revision in monetary policy, the farm finance infrastructure will need to deal more effectively with instability of interest rates. In Saskatchewan, the Agricultural Credit Corporation has helped to provide interest rate stability through the offer of loans to livestock and irrigation enterprises at rates fixed for a specific number of years. Other initiatives to consider in developing a national farm finance policy may include:

(i) Mortgage Interest Rate Insurance

Farmers could be offered insurance that the interest rate on their loan would not exceed a certain specified level. A premium could be charged for this insurance, possibly cost-shared by the farmer and the government.

(ii) Shared Equity Financing

A program of this nature would allow farmers to issue shares to obtain capital as an alternative to debt financing, thus reducing cash flow difficulties during the initial years of a farm enterprise. This form of equity financing would provide tax concessions to investment groups purchasing shares from farm enterprises. Equity financing does not require that returns be made regardless of economic circumstances, thereby reducing the risk of farm bankruptcy during downturns.

(iii) Guarantees for Vendor-Financed Mortgages

A retiring farmer who is prepared to finance the new entrant purchasing his land could be offered a government guarantee against loan default by the new entrant. In return, the farmer would accept a fixed rate or shared-risk mortgage. This program would have the added benefit of keeping the retiring farmer's capital resources in agriculture.

(iv) Agribonds

Investors could be given a tax incentive to purchase agribonds which would provide a pool of funds to lend to farmers at stable interest rates for purchase of farmland, machinery, equipment and other assets.

Revenue Generating Pricing Options

Many nations of the developed world have a form of domestic wheat pricing that can assist farmers. Given the current international wheat trading environment it could be appropriate for Canada to examine its options. Since 1973, farmers have subsidized domestic consumers through the Canada Wheat Board two price wheat system. Over the past decade, real wheat prices have fallen 12% while domestic bread prices have risen 8%. Currently, modification of existing Canada Wheat Board pricing regulations to provide a $5/bushel increase into domestic wheat price would translate into an annual income gain of $367 million for wheat producers in Canada.

Intergenerational Transfer of Farms

Transferring an entire farm enterprise operation from one individual to another poses a difficult financing task. This difficultly is more pronounced in the current period of low farm incomes, high land values, and capital financing costs. National farm finance policy needs to guard against the problems surrounding the transfer of farms in such a climate. The Saskatchewan Farm Purchase program, for example, provides interest rebates to beginning and developing farmers. Other possible initiatives could include:

(i) Registered Farm Investment Fund

Individuals working at off-farm jobs could be allowed to place savings into a tax-exempt farm investment fund. Savings placed in the fund would accumulate at a faster rate and would reduce the beginning farmer's need to debt-finance. The reduced intitial debt load would enhance the new farmer's chance of success.

(ii) Taxation of Part-Time Farmers

Current tax provisions restrict the amount of farm losses which can be claimed against off-farm income thereby discouraging part-time farming as a means of gaining entry into agriculture. Tax rules should be changed to reduce entry barriers into agriculture.

(iii) Land Lease Tax Provisions

Retiring farmers could be offered a tax credit on rental income from land leased to beginning farmers where the retiring farmer also sells a portion of his land to the beginning farmer. The provision would reduce the entrant's need to debt finance and increase the likelihood of survival.

Current Farm Debt Situation

As mentioned previously, many farmers are faced with financial circumstances which have placed them in an extremely tenuous position. For many farmers debt-equity ratios are out of balance and the low farm income, recently exacerbated by successive drought on the prairies, is insufficient to service debt requirements. An analysis of the current economic and financial circumstances suggests that a significant proportion of Canadian farmers are in a situation precipitated by factors totally beyond their influence. A national farm finance policy should recognize the need for special initiatives to help those farmers with a reasonable chance of survival and profitability.

Saskatchewan has targetted programs towards farmers in financial difficulty. Operating and debt consolidation loan guarantees are available to farmers unable to obtain loans from their lending institution. The Farm Land Security Act was passed to restrict farmland foreclosures, thus allowing distressed farmers to restructure their financial balance sheets and to survive until economic conditions improve.

Other initiatives for consideration may include:

(i) refinancing and debt consolidation to restructure debt where appropriate;

(ii) debt deferral and set-aside for potentially viable farmers;

(iii) financial counselling and retraining for those farmers who choose to pursue alternative occupations.

Improved Farm Management and Financial Planning

The changed economic and fiscal climates have affected all sectors of the economy. Management practices used in the 1970s were based on the expectation of continued price inflation, low real rates of interest, supportive world commodity markets, and relative exchange stability. Obviously, the basis for these practices has changed and business management strategies in all sectors of the economy, including agriculture, must change to adapt to the more uncertain world of the 1980s.

A national farm finance policy should recognize the need for the continued development of farm financial management expertise in order for Canadian farmers and farm credit institutions to adapt to today's new economic climate and to prevent a repeat of the events which have occured during the past several years. Indeed, such programs have already been undertaken by some of the provinces. Manitoba, for example, has initiated its Farm Business Groups Program. This is a program which allows farmers to enroll in a two year farm financial management course. Also, Saskatchewan has established the Counselling and Assistance Program for farmers, which provides financial counselling, as well as the guarantee of operating and consolidating loans for farmers having difficulty obtaining funds from commercial lenders.

CONCLUSIONS

It is clear that the financial environment facing Canadian farmers has changed since the 1970s, and has created severe financial stress for many. A review of the monetary policy options and the public and private credit and financial programs is required as part of a new National Agricultural Development Strategy to ensure that they both support the Canadian agricultural economy.

RECOMMENDATIONS FOR ACTION ON FARM FINANCE

1. Canada should adopt a less restrictive monetary policy with lower interest rates.

2. Canada must develop financial instruments that allow producers the option of buffer against short term financial instabilities.

3. Canada must adopt a fiscal and financial climate which facilitates the intergenerational transfer of farms.

4. Canada must introduce incentives to save viable farm operations which are in financial stress due to adverse changes in the economic and fiscal environment.

5. Taxes on farm inputs must be lowered.

6. Canada should examine domestic pricing strategies that would increase financial returns to the farm economy.

7. Governments must work with producers to improve farm management expertise and farm financial planning.